No. 09-86

Supreme Court, U.S.
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In The

Supreme Court of the United States

MICHAEL H. BOULWARE,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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REPLY IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

The government describes Boulware's petition as "fact-bound,"[1] and in some respects it does turn on the particulars of the record below. But this misses the broader point. The Ninth Circuit ignored settled law and exceeded this Court's mandate to sustain the result reached in its prior decision, which this Court had unanimously vacated. If the courts of appeals can insulate their disregard of this Court's decisions through a one-sided reading of the record, then those decisions will lose much of their force.

1. The government cannot cite a single case--civil or criminal--from any court that has imposed the burden that the court of appeals placed on Boulware to meet the "with respect to its stock" requirement. No court has required more evidence on that point than Boulware presented. No court has required "affirmative evidence" of a nexus between stock ownership and the distribution, beyond the evidence that Boulware presented--50% stock ownership, control of the corporation, and evidence (Boulware's tax returns) that he did not treat the distributions as salary. No court has required evidence "excluding all [non-shareholder] scenarios," as the court of appeals did here. Opp. 11. The Ninth Circuit created a brand-new rule that

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[1] Brief for the United States in Opposition at 9 (filed Oct. 21, 2009) ["Opp."]. Boulware's petition will be cited as "Pet."

substantially alters the taxation of distributions to controlling shareholders.

2. The government tries to explain away the dozens of cases that apply the constructive dividend rules without requiring more evidence on the "with respect to its stock" issue than Boulware presented. It argues that those courts were engaged in "deferential review of either the IRS' administrative determination or a jury's verdict." Opp. 12. But the "deferential review" courts afford administrative decisions and jury verdicts closely resembles the "generous" standard that controls a criminal defendant's entitlement to a jury instruction on his defense. App. 6. The Ninth Circuit paid lip service to that standard, but it actually held Boulware to a far more stringent burden, contrary to cases from this Court and the other courts of appeals. Pet. 10-13.

The government also notes that in none of the previous cases applying 26 U.S.C. §§ 301 and 316 did the party opposing constructive distribution treatment challenge the evidence on the "with respect to its stock" issue. Opp. 12-13. The government suggests, in other words, that the lawyers who handled those many cases--including some government lawyers--simply missed a good argument, which government counsel here spotted (albeit not until the government opposed Boulware's petition for rehearing in the court of appeals). It seems far more likely, however, that the lawyers in those previous cases recognized the obvious: that the "with respect to its stock" requirement is readily satisfied by

precisely the kind of evidence Boulware presented here.

3. Boulware noted in his petition that the "with respect to its stock" limitation establishes a binary structure, by which corporate distributions to controlling shareholders either fall under the constructive distribution rules of §§ 301 and 316 or under the various rules that govern distributions in a nonshareholder capacity. Pet. 14-16. The government insists that the Ninth Circuit's approach leaves this structure intact (and does not create a forbidden "tax limbo") because Boulware received the funds in his capacity as an "embezzler" and the distributions are thus taxable as ordinary income under 26 U.S.C. § 61(a). Opp. 11-12.

The Tax Court rejected a closely analogous effort to invoke § 61(a) in *Truesdell v. Commissioner*, 89 T.C. 1280, 1296-99 (1987), and no court since has tried to resurrect it. Indeed, at least since *Truesdell*, no court has considered "embezzler" to be one of the nonshareholder capacities in which a controlling shareholder can receive a corporate distribution. The nonshareholder capacities to which the cases, the relevant Treasury regulation,[2] and the legislative history[3] refer are *legal* capacities--the

[2] *See* 26 C.F.R. § 1.301-1(c) ("Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.").

[3] S. Rep. 1622, 83d Cong., 2d Sess. 231 (1954) ("Subsection (a) accordingly makes clear that section 301 has applicability only to distributions of property to shareholders in their capacity as such. For example, a distribution of property to a shareholder who is a creditor of the corporation in satisfaction of his claim against the corporation is not within the scope of section 301.").

other legal relationships (*e.g.*, employer-employee, creditor-borrower) through which a shareholder can receive funds from his corporation. The government cites no case that treats money that a controlling shareholder such as Boulware obtains through alleged embezzlement as having been received in a nonshareholder capacity.[4] Instead, when a controlling shareholder diverts funds from his corporation, courts apply the taxation rules in § 301(c), regardless of whether the transaction could be characterized under state law as an offense against the corporation. *See, e.g., Drybrough v. Commissioner*, 238 F.2d 735, 738 (6th Cir. 1956); *Estate of Sell v. Commissioner*, T.C. Memo 1992-130, 1992 Tax Ct. Memo LEXIS 455, at *38-*48.

Notably, the government's position here flatly contradicts its position in a series of civil tax cases. In those cases, the IRS has argued successfully that the controlling shareholder of a close corporation *cannot* embezzle from his own corporation. *See, e.g., Stark v. Commissioner*, T.C. Memo 1999-1, 1999 Tax Ct. Memo LEXIS 2, at *12-*13; *Frankland Racing Equipment, Inc. v. Commissioner*, T.C. Memo 1987-210, 1987 Tax Ct. Memo LEXIS 206, at *69; *M.J. Laputka and Sons, Inc. v. Commissioner*, T.C. Memo 1981-730, 1981 Tax Ct. Memo LEXIS 10, at *30; *Federbush v. Commissioner*, 34 T.C. 740, 750-51 (1960), *aff'd*, 325 F.2d 1 (2d Cir. 1963) (per curiam).

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[4] The sole case the government cites on this point--*James v. United States*, 366 U.S. 213 (1961)--did not involve distributions by a corporation to a controlling shareholder, nor did it interpret §§ 301 and 316.

In each of these cases, the corporate taxpayer claimed a deduction for a theft loss under 26 U.S.C. § 165 based on a controlling shareholder's diversion of funds from the corporation, and the IRS opposed the deduction. In *Frankland Racing Equipment*, for example, the IRS argued that "no embezzlement occurred where a dominate [sic] shareholder misappropriates corporate monies as the requisite intent to embezzle is absent." 1987 Tax Ct. Memo LEXIS 206, at *69. The Tax Court agreed. It found that Frankland (the controlling shareholder) "had no intent to embezzle from Frankland Racing as his objective was to conceal the financial performance of the corporation from [his wife] and to evade tax. The funds diverted pursuant to the scheme are accurately classified as constructive dividends." *Id.*

In *M.J. Laputka and Sons*, the Tax Court agreed with the IRS' argument that "inasmuch as the shareholders who misappropriated the money also dominated the corporation, it would be anomalous to say that there was the requisite intent to embezzle. They would be taking money from themselves, and this does not constitute embezzlement." 1981 Tax Ct. Memo LEXIS 10, at *30. The court concluded: "The money diverted by [the controlling shareholders] and used by them for their personal benefit is more accurately described as disguised dividends to them." *Id.* at *31. Having argued successfully in these and other cases that a controlling shareholder cannot embezzle from his own corporation, the government should not be

permitted to take a contrary position here merely to insulate the court of appeals' decision from review.[5]

4. In addition to contradicting the government's position in prior cases, the "embezzler" theory has a second flaw. Even if a controlling shareholder can embezzle from his own company, and even if that embezzlement bears upon a return of capital claim, in a criminal case such as this the Sixth Amendment requires that the defendant's embezzlement be determined by the jury. In its last appearance before the Court, the government made the same "embezzler" argument. Although the Court "decline[d] to address whether an unlawful diversion may ever be deemed a 'distribution . . . with respect to [a corporation's] stock,'" it rejected the government's contention that the jury had already found that Boulware embezzled from HIE. The Court declared: "[T]he jury was not asked, and cannot be said to have answered, whether Boulware breached any fiduciary duty as a controlling shareholder, unlawfully diverted corporate funds to defraud his wife, or embezzled HIE's funds outright." *Boulware v. United States*, 128 S. Ct. 1168, 1181 (2008). The government still lacks a jury determination on the embezzlement theory, and it cannot use that theory here to justify the Ninth Circuit's decision on remand.

5. The government insists that the Ninth Circuit had the "discretion" to consider the basis

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[5] Of course, if the government's embezzlement theory were correct, then HIE--the corporation from which Boulware allegedly embezzled--would be entitled to a theft deduction under § 165 for the years in question.

issue that the government forfeited below and did not dispute in this Court. Opp. 14. But the government's appeal to "discretion" masks the shell game it has played. In the district court and before the Ninth Circuit panel, it relied exclusively on the "contemporaneous intent" requirement from *United States v. Miller*, 545 F.2d 1204 (9th Cir. 1976). At the petition for rehearing stage, the government introduced the "with respect to its stock" and basis issues--neither of which it had previously urged. Before this Court, the government abandoned contemporaneous intent and basis and focused on "with respect to its stock." On remand, the government argued "with respect to its stock" and reintroduced basis. The court of appeals has allowed the government to get away with this shape-shifting while holding Boulware strictly to the record he made in the district court, where the sole contested issue was the *Miller* contemporaneous intent standard. *E.g.*, App. 13 n.5, 15 n.9. That double standard is profoundly unfair.

Apart from the unfairness of the Ninth Circuit's approach on remand, its consideration of the basis issue plainly exceeded the scope of this Court's remand. Fairly read, the remand left two issues open: whether Boulware had presented enough evidence on the "with respect to its stock" issue to obtain a return of capital instruction, and whether embezzlement by a controlling shareholder from his corporation can preclude application of §§ 301 and 316. *See* 128 S. Ct. at 1180-82. Nothing in the Court's opinion suggests that it intended the court of appeals to resurrect an issue--basis--that the government had not raised in the district court, had

not raised before the court of appeals panel, and did not dispute in this Court.

6. The government ignores a further point, noted at Pet. 19 n.7: contrary to the court of appeals' decision (App. 15), it was not necessary for Boulware to offer evidence of "a stock basis in excess of $10 million" to present the return of capital defense. The jury never found that Boulware diverted that amount of money; it merely found an *unquantified* tax deficiency or understatement of income for each year and count in question. The alleged $10 million diversion consisted of money in varying amounts from varying sources received over a period of years. Boulware's alternative defenses (other than return of capital) varied from one sum to another; the jury may have credited some defenses for some amounts of money and disbelieved others.

The court of appeals acknowledged that Boulware presented evidence of millions of dollars in basis. App. 15. Even if that evidence fell short of the full $10 million at issue, it sufficed to meet Boulware's burden of production under the "generous" standard for obtaining a defense instruction.

CONCLUSION

For the foregoing reasons, and for the reasons stated in Boulware's petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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